Subprime Lending

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

IMPORTANT
These guidelines are intended to be used in conjunction with other applicable lending modules. Use of these guidelines should be coordinated with other examination procedures to avoid duplication. For example, if the bank makes subprime credit card loans, these guidelines should be used in conjunction with the loan reference module for credit card activities.

PRELIMINARY REVIEW

1 Review prior examination reports and file correspondence for information concerning subprime lending.

2 Identify portfolios considered by management to be subprime.

3 Identify other potential subprime portfolios by reviewing:

3A Underwriting guidelines such as high debt to income ratios, low credit scores, and tarnished or limited credit repayment history.

3B Interest rates and fees on loans. High interest rates and fees are a common and relatively easily identifiable characteristic of subprime lending. However, it should be noted that high interest rates and fees by themselves do not constitute subprime len

3C Target market such as individuals who have previously declared bankruptcy.

4 Determine if there has been any significant changes in subprime loan policies, products offered, or volume since the previous examination.

5 Determine the institution’s organizational structure for managing subprime products and activities.

6 Determine if activities are outsourced. If so, obtain a list of third parties utilized. Third parties may include brokers, marketing firms, collection firms, servicing firms, correspondents, affinity partners, and information systems firms.

7 Review outstanding litigation, consumer complaint information, and prior compliance examination reports for information concerning subprime lending.

8 Review internal and external audit reports or independent reviews.

POLICY CONSIDERATIONS

9 Review the bank’s strategic or business plan with respect to subprime lending and determine if:

9A Subprime products offered and planned are consistent with the overall business strategy and stated risk tolerances and are offered as envisioned by the plan (volume, growth, performance, markets served, etc.).

9B The plan sets forth clear objectives for performance including the identification of target markets, customers, and performance bench marks (i.e., profitability, asset quality, etc.) for each segment and the portfolio as a whole.

9C The plan establishes limitations on growth, volume, and concentrations by product, collateral type, customer type or loan grade, and source of origination.

9D The plan appropriately addresses the attendant risks, including credit, operating, liquidity, compliance, interest rate, legal, and reputation risk.

9E The plan, including projections and assumptions used, is reasonable in light of economic, market, and competitive conditions, management expertise, technological and operational capacity, and capital support.

9F A clear solicitation and origination strategy has been established that allows for after-the-fact assessment of underwriting performance.

9G The plan adequately provides for appropriate control systems (risk management, loan review, audit, and quality assurance) to provide the necessary level of oversight.

9H Customer retention issues have been addressed.

10 Determine if written subprime lending policies and procedures adequately address the following items:

10A Permissible types of subprime loans and those not authorized.

10B Portfolio targets and limits for each credit grade or class.

10C Lending and investment authority for individual officers, supervisors, and loan committees.

10D A framework for pricing and profitability analysis that considers all costs associated with the loan, including origination and administrative/servicing costs, expected charge-offs, funding cost, and capital.

10E Collateral guidelines addressing: required/eligible collateral; monitoring of collateral values with initial and periodic evaluations; process to select and manage a list of approved appraisers and other sources of collateral evaluation; and verification of collateral information.

10F Well-defined underwriting parameters (e.g., acceptable loan term and amount, debt to income ratio, loan to collateral value ratio, minimum acceptable credit score) that are consistent with applicable supervisory guidelines. Credit or risk grades should contain minimum and maximum criteria for each grade. The lowest grade should not be a catch-all that includes everything below the maximum criteria. Institutions should set underwriting and pricing guidelines for each credit grade targeted.

10G Requirements for verification of applicant information that includes, at a minimum, address, income, and employment information.

10H Procedures for tracking and monitoring loans approved as exceptions to policy guidelines.

10I Credit file documentation requirements (e.g., applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memo to support the loan decision).

10J Third party management process, including measures to ensure loans originated through this process meet the institution's lending standards.

10K Concentrations of credit (e.g., geographic, product type, source of origination/recourse).

10L Cure programs allowed, if any, and requirements for eligibility that are in conformance with the Uniform Retail Credit Classification and Account Management Policy.

10M Billing, collection, foreclosure, and repossession procedures.

10N Content and frequency of management reports.

10O Loan review and ALLL methodology that recognizes subprime loans as a specific risk exposure.

10P Prudent asset classification and charge-off criteria. While subprime loans generally fall under the umbrella of the Uniform Retail Credit Classification Policy, the standards in the Uniform Policy are considered minimums. Subprime lenders should if warranted adopt more conservative policies based upon portfolio analysis specific to their institution.

11 Determine if compensation programs promote behaviors that are consistent with portfolio objectives and risk tolerances.

12 Assess management’s procedures for handling litigation.

INTERNAL CONTROLS

13 Evauate controls in place to ensure adherence to policies and procedures.

14 Determine if management tracks exceptions in the following areas.

14A Underwriting.

14B Collateral.

14C Documentation.

14D Credit grading.

14E Pricing.

14F Credit score overrides.

14G Over-limit accounts.

15 Determine if management tracks exceptions by individual account, as well as, aggregate trends.

16 Determine if management tracks the source of exceptions such as employee, specific dealer or broker, or other origination channel.

17 Determine if the information tracked is used to:

17A Measure additional risk overall and by channel.

17B Make adjustments to policies and procedures.

17C Identify training needs.

17D Provide input for personnel evaluations and compensation programs.

18 Determine if new product development processes require appropriate approval prior to implementation.

19 Determine if data integrity is regularly tested.

20 Determine if a system is in place to monitor consumer complaints for recurring issues and appropriate disposition.

AUDIT OR INDEPENDENT REVIEWS

21 Assess the adequacy of the scope of the audits or independent reviews of subprime activities.

INFORMATION AND COMMUNICATION SYSTEMS

22 Determine if appropriate key measurements are monitored, as a whole and for various subprime portfolio segments, such as:

22A Profitability.

22B Growth.

22C Policy overrides.

22D Delinquencies.

22E Losses.

22F Credit scores.

22G Debt-to-income ratios.

22H Loan-to-value ratios.

22I Concentrations.

23 Determine if management adequately segments the portfolio for monitoring such as by: product, vintage, marketing initiative, credit risk grade, and source of account acquisition.

24 Determine if management utilizes vintage analysis, lagged delinquency and loss reports, and migration analysis to account for the effects of portfolio growth and seasoning.

25 Assess the adequacy of MIS available for managing vendors.

26 Ascertain the accuracy of the institution’s system for reporting past due status.

PORTFOLIO ANALYSIS

27 Analyze the portfolio utilizing management’s reports (e.g., vintage analysis, lagged delinquency and loss reports, migration analysis, etc.).

28 Determine the credit risk composition of the subprime portfolio. Subcategories in subprime lending can vary widely and reflect varying degrees of risk from A- grade residential real estate loans to a D grade used auto loans.

29 Determine the extent to which ongoing portfolio quality analysis includes review of changes in customer creditworthiness over time. This information promotes proactive account management activities (e.g., line increase or decrease, early intervention, counseling, credit grade increase or decrease, and cross-selling).

30 Determine if management analyzes defaulted loans and loans not performing as expected to determine the reason for the poor performance.

31 Assess the impact of cure programs on reported portfolio performance and profitability.

32 Review a sample of loans made during the review period, including new accounts originated in the past quarter, for the following:

32A Adherence to policies and procedures.

32B Adequacy of policy exceptions monitoring.

32C Accuracy of past due status.

33 Determine whether geographic, customer base, source of account, loan type, or other concentrations exist, and identify the unique risks posed by any of the portfolio segments or concentrations. Evaluate the degree of risk and consider mitigating factors.

34 Determine if consumer complaint information and outstanding litigation points to significant weaknesses in the bank's subprime activities.

35 Determine if products marketed to loan customers or fees charged in connection with the loans comprise a significant portion of the loan amount advanced. If significant, consider the potential impact on repayment.

36 Determine the level of subprime loan classifications.

36A Based on portfolio analysis, determine the level of classifications. While subprime loans generally fall under the umbrella of the Uniform Retail Credit Classification Policy, the standards in the Uniform Policy are considered minimums. Given the high risk nature of subprime loans, more stringent classifications than the Uniform Policy may be warranted.

36B Consider the institution's migration analysis when determining Substandard, Doubtful, and Loss classifications. Such an analysis may evidence a need for more stringent classification. For example, if migration analysis reflects that substantially all of the institution's subprime loans past due 90 days or more eventually flow to charge-off, it may be appropriate to classify loans over 90 days past due as Loss.

36C Consider management and control weaknesses. If management and control weaknesses have resulted in an overall deterioration in portfolio quality, consider adversely classifying the entire portfolio, or portions therein, to reflect the severity of credit quality problems. Subprime portfolios with a material volume of loans 90 days or more delinquent indicate weaknesses in the institution's collections or other control procedures.

ALLOWANCE FOR LOAN AND LEASE LOSSES

37 Determine if the written ALLL analysis adequately documents the factors considered in evaluating subprime portfolios.

38 Determine if the institution's ALLL methodology:

38A Segments subprime lending portfolios by risk exposure such as specific product, vintage, origination channel, risk grade, loan to value ratio, or other grouping deemed relevant.

38B Considers changes in underwriting standards, collection practices, cure programs, foreclosure practices, and repossession practices.

38C Considers subprime portfolio growth.

38D Considers economic factors such as delinquency trends of portfolios that have not been subject to an economic downturn.

SERVICING AND COLLECTIONS

39 Assess the structure, management, and staffing of the servicing and collections department and determine:

39A The structure of the department (i.e., centralized at one office or decentralized).

39B If management and staff possess the necessary expertise.

39C If management collects appropriate data to determine staffing levels.

39D If the number of personnel in the department is sufficient to expeditiously manage the volume of collections and repossessions.

40 Evaluate the adequacy of staff training.

41 Determine if servicing provides for accurate and timely new loan setup.

42 Evaluate the institution's servicing and collection strategies. Below are some common communication techniques utilized in the subprime lending industry.

42A Early and frequent bank-initiated communication with customers.

42B Welcome calls within two days after origination to review loan terms, answer questions, and verify information.

42C Monthly statements instead of payment coupon books.

42D Reminder calls several days before the payment due date.

42E Late payment calls shortly after a missed payment date.

42F Technology based collections.

42G Default letters.

43 Evaluate cure programs used, such as loan restructures, re-agings, deferrals, and fixed payment plans. Specifically determine if:

43A Eligibility requirements are reasonable and based upon a renewed willingness and ability to repay.

43B Terms of the restructure are appropriate.

43C Programs are in compliance with the Uniform Retail Credit Classification and Account Management Policy.

43D Any practices are in place whereby third parties purchase/fund loan payments to cure loan delinquencies and assess impact.

43E Management monitors the performance of loans that have been subject to cure programs to determine the effectiveness of such practices and the impact on the past due ratio.

44 Evaluate the institution's repossession and collateral re-marketing strategies.

SCORING MODELS

45 Determine whether models are custom or vendor supplied and what they are being used for (e.g., approvals, pricing, loss estimates, collections).

46 Determine whether the development process is consistent with the bank's risk appetite and desired level of subprime loans.

47 Review the documentation supporting the institution's scoring models and determine if:

47A Models are empirically derived and statistically sound.

47B Scoring is based upon a developmental population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered.

47C Assumptions and customer characteristics are reviewed frequently and updated to effectively predict credit performance.

47D Credit scores permit the institution to predict overall risk and the potential impact on collection activities.

47E Models consider delinquencies and losses over varying economic conditions.

48 Evaluate the ongoing monitoring and maintenance process in view of the portfolio's performance and determine if:

48A Models are actively monitored, adjusted, and periodically revalidated.

48B Systems continue to reflect current underwriting standards and risk parameters.

48C Management maintains an adequate portfolio chronology log to record significant events related to the credit acquisition process for each subprime portfolio.

48D Scoring systems are supervised and maintained in accordance with vendor-provided specifications and recommendations.

48E Models are adjusted to account for unexpected events.

PROFITABILITY

49 Assess the adequacy of the bank's process for pricing products, as well as, projecting and tracking profitability and determine if:

49A The process considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, funding cost, and capital.

49B Profitability analysis includes various segments of the portfolio such as by: product, credit risk grade, vintage, marketing initiative, source of account acquisition, and account customer.

50 Review the most recent fiscal year-end and current year-to-date financial information for each subprime product, and compare to budgets and forecasts to determine significant variances.

51 Determine the type and level of fee-based income received and review trends.

52 Consider the extent to which fees are a recurring and viable source of revenue.

53 Review subprime profitability, assessing the impact of product performance, plans, and modifications. If applicable, consider the impact of gain on sale accounting on the quality of earnings.

CAPITALIZATION

54 Review the bank's methodology for determining additional capital needed to offset the additional risk taken in subprime lending activities. Determine if the methodology is well documented and reasonable.

55 Determine if the methodology provides for additional capital in consideration of the following:

55A Liquidity, market, legal, compliance, reputation, and operating risks associated with subprime lending contribute to a higher risk profile compared to traditional bank activities.

55B Capital should provide for the volatility in losses associated with subprime lending and the resultant unanticipated losses.

55C Type and amount of collateral.

55D Credit risk composition of the portfolio (e.g., A-, B, C, D).

55E Staff expertise in subprime lending.

55F Resources available to service and collect the subprime portfolio.

55G Dependence upon securitization activities for funding subprime loans.

55H The degree of portfolio concentration in subprime loans.

55I Growth trends.

55J Reliance upon underwriting techniques untested in an economic downturn (e.g., credit scoring).

55K The economic conditions in the institution's market area.

THIRD PARTIES

56 Determine if the institution performs and documents a due diligence process both prior to engaging the services of a third party and on an ongoing basis.

57 Determine if the due diligence process regarding third parties includes the procedures below.

57A Determine whether the third party has the operational and financial capacity and expertise to perform the service.

57B Perform background checks on third parties' principals and key individuals including bank and trade references, credit report, and criminal background.

57C Annual financial analysis, at a minimum, of third parties and their principals to ensure ability to perform on recourse commitments.

57D Development of controls such as recourse provisions for loan/account originators, customer information security, and access to bank information.

57E Periodic review of third parties' operations such as staffing level, marketing plans, sales techniques, and customer service practices.

57F Review of audit reports of third parties.

57G Periodic on-site inspections.

57H Quality assurance reviews which monitor compliance with the service agreement, the institution's policies and procedures, and laws and regulations.

57I Maintenance of contingency plans if the third party performs any critical functions for the institution.

57J Maintenance of current and complete contracts.

58 Determine if the institution's due diligence review prior to purchasing loans includes:

58A A determination that loans meet the institution's underwriting criteria.

58B Adequate consideration for the cost of servicing and expected losses when evaluating expected profits.

59 Determine if management tracks the quality of accounts obtained through each channel. Determine if the items tracked includes the following:

59A Delinquencies.

59B Charge-offs.

59C Profitability.

59D Documentation.

59E Collateral and underwriting exceptions.

59F Compliance with laws.

59G Consumer complaints.

60 Determine if conflicts of interest exist in the third parties' duties. For example, if a loan originator provides recourse for poorly performing loans purchased by the institution, the originator should not also be responsible for processing/determining the past due status of the loans.

61 Determine if affiliate or insider relationships exist with third parties and if so, perform procedures under the Related Organizations Supplemental Modules.

62 Assess concentration risks in customer base and origination source.

63 Assess third parties’ financial capacity and ability to perform on recourse commitments.

64 Determine if management has taken into consideration its legal responsibility arising from the consumer compliance risks associated with outsourcing.

65 Determine if the bank has obtained a legal review of contracts.

66 Review contracts for the following information:

66A Clearly defined duties and responsibilities, including services to be performed and time frames.

66B Fee structure with fees tied to performance.

66C Remedies to protect the bank if the third party fails to perform and terms of renegotiation.

66D Prohibitions concerning the ability to assign the agreement or delegate responsibilities to a third party.

66E Criteria for acceptability of accounts solicited (i.e., underwriting guidelines).

66F Specified ownership of account relationships/data.

66G Allowable use of the name and logo of each party.

66H Frequency and means of communication and monitoring of each party.

66I Records each party must maintain, as well as, allow access to the records.

66J Frequency and type of financial statements and audit reports to be required.

66K Warranties that applicable consumer and other laws are followed.

66L Right of institution to perform an audit and on-site inspection.

66M Maintenance of an adequate contingency plan by the vendor should it fail to perform any critical function for the institution’s program.

66N Security of customer information.

SECURITIZATIONS

67 Determine if management has developed a contingency plan addressing back-up purchasers of the securities or attendant servicing functions, alternate funding sources, and measures for raising additional capital.

68 Determine if the institution has consulted auditors regarding appropriate accounting and valuation. Review auditor comments.

69 Review the accounting for the financial assets and liabilities and gains or losses associated with the securitizations for compliance with Consolidated Reports of Income and Condition instructions. Consider the following unique characteristics of subprime loan securitizations.

69A Financial assets in the form of interest only strips receivable and other retained interests associated with subprime loan securitizations generally lack an established market, require assumptions that can be difficult to reliably quantify, and may not have an estimate of fair value that is practicable. As a result, these assets may have little or no value.

69B Prepayment speeds can be higher than for prime loans, regardless of market interest rates, due to refinancing of debt at lower interest rates based on improvement in credit quality.

69C Prepayment, loss, and default rates in the subprime markets are generally more volatile than in the prime market resulting in higher discount rates for uncertainty of cash flows.

69D Servicing revenues can vary significantly. Management should compare actual cash flows received with projected amounts to ensure that assumptions remain reasonable.

70 Determine if key accounting assumptions such as discount, default, credit loss, and prepayment rates used by management are conservative and well-supported both for initial valuation and for subsequent quarterly reevaluations.

71 Determine if the structure of the securitization requires loans sold and removed from the balance sheet to be treated for risk based capital purposes as financial assets sold with recourse per Consolidated Reports of Income and Condition instructions.

72 Determine if management, when making valuation assumptions, segments securitized assets by specific pool, as well as, predominant risk and cash flow characteristics.

73 Evaluate the performance of asset-backed securities supported by subprime loans. Determine if:

73A Performance trends are stable, improving, or deteriorating.

73B Early amortization or other credit enhancement triggers are nearing their set-off points. If so, discuss with management the potential liquidity and reputation risk issues.

73C The institution has been called upon to provide financial support to enhance the quality and performance of loan pools it has securitized.

74 Determine if delinquency and loss rates are similar for both the owned and the securitized subprime portfolio. If the delinquency and loss rates deviate significantly, determine if management is selectively prioritizing loans by either high credit quality or superior past credit history and setting them aside for asset securitization.

75 Determine if any significant concentrations in high risk assets arise from interest-only strips receivable or other retained interests that are recorded in connection with the securitization transaction.

MANAGERIAL EFFECTIVENESS

76 Review remedial actions taken by management to correct audit and examination deficiencies.

77 Determine if management has provided the specialized expertise, staffing, and training in light of the subprime portfolio’s volume, performance, and future plans.

78 Determine if management periodically evaluates whether the subprime program has met profitability, risk, and performance goals.

79 Analyze management’s response to any adverse performance trends, such as higher than expected prepayments, delinquencies, charge-offs, customer complaints, and expenses or lower than expected profitability.

80 Determine if the institution’s response to significant policy variations is appropriate.

81 Determine whether the level of policy exceptions results in higher levels of delinquencies and losses, indicative of weaknesses in the underwriting process.

82 Interview staff regarding knowledge and use of policies and procedures.